

**REPORT OF EXAMINATION**  
**SAFECO LIFE INSURANCE COMPANY**

**Redmond, Washington**

**December 31, 2000**




**States Participating:**

**Washington**  
**Delaware**  
**Nevada**

## CHIEF EXAMINER'S AFFIDAVIT

I hereby certify that I have reviewed the attached Report of Examination of the financial condition and affairs of SAFECO LIFE INSURANCE COMPANY of Redmond, Washington, as of December 31, 2000.

A handwritten signature in black ink, reading "Patrick H. McNaughton", written over a horizontal line.

Patrick H. McNaughton  
Chief Examiner

9-11-03

\_\_\_\_\_  
Date

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## **SALUTATION**

Seattle, Washington  
August 27, 2003

The Honorable Alfred W. Gross  
Commissioner,  
Commonwealth of Virginia  
Chair, NAIC Financial Condition (EX) Committee  
State Corporation Commission  
Bureau of Insurance  
PO Box 1157  
Richmond, VA 23218

The Honorable John Morrison  
Commissioner, Montana Department of  
Insurance  
NAIC Secretary, Western Zone  
840 Helena Avenue  
Helena, MT 59601

The Honorable Susan F. Cogswell  
Commissioner, Connecticut Department of  
Insurance  
NAIC Secretary, Northeastern Zone  
PO Box 816  
Hartford, CT 06142-0816

The Honorable Mike Kreidler  
Commissioner, Washington State Office of  
Insurance Commissioner  
5000 Capitol Boulevard  
PO Box 40255  
Olympia, WA 98504-0255

Dear Commissioners:

In accordance with your instructions and in compliance with the statutory requirements of Chapter 48.03 of the Revised Code of Washington (RCW), an Association Examination was made of the corporate affairs and financial records of the

### **SAFECO LIFE INSURANCE COMPANY** of Redmond, Washington

hereinafter referred to as the "Company" or "SAFECO Life", at its home office located at 5069 154th Place NE, Redmond, Washington 98052.

The Company offered individual and group insurance products, retirement services and annuity products. The Company was licensed in all states except New York and was licensed in the District of Columbia. A listing of the Company's affiliates and the Company's relationship as a member of an insurance holding company system is included in this Report of Examination under the caption "AFFILIATED COMPANIES". The Company was under the control of and managed by a Board of Directors. Officers were appointed by the Board of Directors to operate the Company. The Company's reinsurance transactions did not involve Company affiliates and were considered normal for a company of this size.

The last examination was as of December 31, 1995. The following Report of Examination is respectfully submitted showing the condition of the Company as of December 31, 2000.

## **SCOPE OF EXAMINATION**

Per RCW 48.03.010, the examination covered the five-year period from January 1, 1996 through December 31, 2000. The Company was last examined as of December 31, 1995 by examiners representing Washington, Delaware and Ohio. On April 19, 2001, an Association Examination was called to begin on June 4, 2001. Insurance examiners from the states of Washington, Delaware and Nevada conducted the current examination concurrently with the Association Examination of five other companies domiciled in Washington - General Insurance Company of America, First National Insurance Company of America, SAFECO Surplus Lines Insurance Company, SAFECO Insurance Company of America and SAFECO National Life Insurance Company. The Southeastern and Midwestern Zones of the National Association of Insurance Commissioners (NAIC) were invited to participate in the examination but elected to decline.

A December 31, 2000 examination of SAFECO National Insurance Company was conducted concurrently by the Missouri Insurance Department. December 31, 2000 examinations of SAFECO Insurance Company of Illinois and its subsidiary, Insurance Company of Illinois, were conducted concurrently by the Illinois Insurance Department.

The examination of the Company was conducted in accordance with the laws of the state of Washington contained in Title 48 RCW and regulations contained in Title 284 Washington Administrative Code (WAC) and the examination procedures prescribed by the NAIC Financial Condition Examiner's Handbook.

Corporate records and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. Comments on any adverse findings that are applicable to the current examination are included in the "INSTRUCTIONS", "COMMENTS AND RECOMMENDATIONS" and "ACCOUNTS AND RECORDS" sections of this report.

## **INSTRUCTIONS**

The examination disclosed the following issues that require Company action:

### **1. Inadequate Accounts and Records**

**Our examination of the Company disclosed numerous areas in which the Company's accounts and records were found to be deficient, insufficient, or inaccurate to provide for and ensure full and adequate disclosure. The Company is instructed to comply with RCW 48.05.280 which requires the Company to keep full and adequate accounts and records of its assets, obligations, transactions and affairs. The results of the examination disclosed the following insufficiencies, errors, and inadequacies:**

- a) The Company was unable to provide the Examination team with signed and notarized copies of the 1996, 1997, 1998 and 1999 Regular Annual Statements and Separate Accounts Annual Statements.
- b) WM Life Insurance Company (WM) was merged into the Company effective July 1, 1998. WM had a custodial account with The Bank of New York where it held securities in connection with reinsurance assumed from US Life Credit Life Insurance Company (name changed to American General Assurance Company). When this was brought to the Company's attention by the examiners during the examination, July 31, 2001, custodial account No. 375711 was closed and the securities were distributed to the appropriate parties.

WM Life Insurance Company had a custodial account with The Bank of New York where it held securities in connection with reinsurance assumed from Midwestern United Life Insurance Company. When this was brought to the Company's attention by the examiners during the examination, October 15, 2002, the name on account 375710 was changed from WM Life Insurance Company to SAFECO Life.

Three of the Scudder mutual funds listed in the Company's 2000 Separate Account Annual Statement were in the name of WM Life Insurance Company. The Company had the mutual funds registered in the Company's name when this was brought to the Company's attention by the examiners during the examination.

- c) Empire Life Insurance Company (Empire) was merged into the Company effective January 1, 2000. Empire had a January 2, 1998 custodial agreement with The Bank of New York. When this was brought to the Company's attention by the examiners during the examination, January 25, 2002, custodial account No. 107301 was closed and the assets held under this custodial agreement were transferred to the Company.

Schedule E, Part 2 (Special Deposits) of the Company's 2000 Annual Statement included a statutory deposit having a par value of \$220,000 held by the state of Arizona. The \$220,000 statutory deposit was in the name of Empire Life Insurance Company and was released to the Company when this was brought to the Company's attention by the examiners during the examination, January 23, 2002.

- d) Schedule DB, Part C, Section 1 of the Company's 2000 Annual Statement reported a SWAP with Goldman Sachs. The SWAP was issued in the name of SAFECO Insurance Company rather than in the name of SAFECO Life Insurance Company. The failure to have SWAP No. 2 issued in the name of the Company was considered a violation of RCW 48.12.010, which requires assets to be registered, recorded or held in the insurer's name, and of RCW 48.05.280 which requires the Company to keep full and adequate accounts and records of its assets, obligations, transactions and affairs.
- e) The direct confirmation received from Merrill Lynch International included among the SWAPS owned by the Company a SWAP in the name of SAFECO Asset Management Company on behalf of SAFECO Life Insurance Company that was not listed as an open SWAP in Schedule DB, Part C, Section 1 of the Company's 2000 Annual Statement. This SWAP, No. 38

maturing November 17, 2003, was reported in the 2000 Annual Statement of American States Life Insurance Company, an affiliate. The SWAP was terminated March 21, 2002.

The direct confirmation received from Merrill Lynch Capital Services included among the SWAPS owned by the Company a SWAP in the name of SAFECO Life Insurance Company that was not listed as an open SWAP in Schedule DB, Part C, Section 1 of the Company's 2000 Annual Statement. This SWAP, No. 39 maturing November 17, 2003, was reported in the 2000 Annual Statement of American States Life Insurance Company, an affiliate. The SWAP was terminated March 22, 2002. The Company indicated that SWAP Nos. 38 and 39 were issued in the Company's name in error, as they were investments made by the Company's affiliate.

- f) Exhibit 2 of the Company's 2000 Annual Statement reported \$1,398,216 collected on derivative instruments. The Company was unable to support \$449,298 of the \$1,398,216.
- g) Confirmations received from the counterparties holding the SWAPS as of December 31, 2000, provided market values assigned by the counterparties. The market values reported by the counterparties were not in agreement with the statement values reported by the Company in Schedule DB, Part C, Section 1 of the 2000 Annual Statement. The largest variance was \$634,232; however, the total net variance of \$50,167 was not considered to be material.
- h) The confirmations received directly from thirteen of the forty-four mutual funds and trusts listed in Schedule D, Part 2, Section 2 of the Company's 2000 Separate Account Statement included shares owned by First SAFECO National Insurance Company of New York, a wholly-owned subsidiary. During the examination, the shares owned by the New York company were transferred out of the name of SAFECO Life Insurance Company into separate mutual fund accounts set up in the name of the New York company.
- i) The Company had twenty-four custodial accounts with The Bank of New York for its Separate Accounts as of December 31, 2000. Account No. 318571 was in the name of "SAFECO" rather than SAFECO Life Insurance Company. When this was brought to the Company's attention by the examiners during the examination, on August 2, 2001, the Company had the custodial bank change the account name to the Company's corporate name.
- j) The results of our examination disclosed numerous bank accounts, within the Company and the SAFECO Group, that were not reconciled on a timely basis. As of mid-2001, within the SAFECO Group of companies, there were over 9,500 "variances" between the bank statement balances and the G/L balances, many of which had to be corrected by entries to the G/L. The variances totaled over \$1,000,000,000, and they were comprised of overstatements and understatements which resulted in an approximate net debit of \$300,000,000.

When this was brought to the attention of the Company during the examination, the Company took immediate action and brought in an outside consultant to assist in reconciling these accounts. By the end of the examination field work, the Company had reduced the outstanding net debit balance to an immaterial amount.

- k) The results of the examination disclosed numerous internal control deficiencies, some of

which are detailed in the "ACCOUNTS AND RECORDS" section of this report. Pursuant to RCW 48.05.280, the Company is required to ensure that all accounting controls be reviewed, and deficiencies identified and corrected.

## **2. Insurer Holding Company Act Violations**

In addition to the Holding Company Act violations for the transactions with Barrier Ridge LLC (see "INSTRUCTIONS" No. 3.), and the Company's investment in Principal Protected Equity Linked Trust recorded in the name of SAFECO Asset Management Company (see "INSTRUCTIONS" No. 5), the Company had the following violations of the Holding Company Act:

- a) Funds used by the Company to purchase mutual fund shares for the Separate Accounts were deposited in a bank account maintained by the Company which was in the name of "SAFECO Life Pension". When additional mutual fund shares were purchased for the Separate Accounts, funds in the SAFECO Life Pension account were transferred to an account in the name of "SAFECO Services Corp" maintained at US Bank. When mutual fund shares were redeemed by Separate Accounts, the proceeds received from the mutual funds were deposited in the "SAFECO Services Corp" account maintained at US Bank before being transferred to the "SAFECO Life Pension" account. The Company did not deal directly with the mutual funds.

SAFECO Services Corporation, an affiliate organized in 1972, was the transfer agent for the SAFECO mutual funds. The Company did not have a written agreement with SAFECO Services Corporation specifying the parties' rights, duties and compensation. Transactions made with SAFECO Services Corporation during the period under review were not included in the Holding Company Reports filed with the OIC.

- b) The Company had an August 31, 2000 International SWAPS Dealers Association (ISDA) master agreement with an affiliate, SAFECO Financial Products, Inc. An attachment to the ISDA Credit Support Annex provided that SAFECO Corporation unconditionally guarantees SAFECO Life the due and punctual payment of any amounts payable by SAFECO Financial Products, Inc. Schedule DB, Part A, Section 3 of the Company's 2000 Annual Statement reported \$15,987,034 in S&P 500 index options purchased from the affiliate.

SAFECO Financial Products, Inc., an affiliate organized in 2000, engaged in writing S&P 500 index options, selling single credit default SWAPS and investing in convertible bonds. The Company did not produce a written agreement with SAFECO Financial Products, Inc., specifying the parties' rights, duties and compensation. Transactions made with SAFECO Financial Products, Inc., during the period under review were not included in the Holding Company Reports filed with the OIC.

- c) Open SWAPS No. 29, No. 31 and No. 41 reported as derivative instruments in Schedule DB, Part C, Section 1 of the Company's 2000 Annual Statement were recorded in the name of SAFECO Asset Management on behalf of SAFECO Life Insurance Company. The Washington holding company statutes require an intercompany agreement for these transactions that complies with RCW 48.31B.030(1)(a).



- d) SAFECO Asset Management Company (SAM), an affiliate acquired by SAFECO Corporation in 1973, serves as the investment advisor for the Company and its affiliates. Numerous investment transactions were conducted between the Company and SAFECO Asset Management Company during the five-year period under review for which no intercompany agreement was in force to define the rights and responsibilities and cost reimbursement methodologies.

These affiliate services performed by SAM are required to be "fair and reasonable" as to terms and charges pursuant to RCW 48.31B.030(1)(a)(i) and (ii). In addition, RCW 48.31B.030(1)(a) requires: "(iii) Expenses incurred and payment received must be allocated to the insurer in conformity with customary insurance accounting practices consistently applied; (iv) The books, accounts, and records of each party to such transactions must be so maintained as to clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties."

- e) Amendment No. 361 to the Insurance Holding Company Registration Statement did not include a \$2,525,000 transfer of KRT Organization Corporation bonds from the Company to American States Preferred Insurance Company, an affiliate, on December 21, 1999, and contained a number of errors as to book values, gains, and losses.

**The Company is instructed to ensure compliance with all pertinent sections of Chapter 48.31B RCW. In addition, the Company is instructed, pursuant to RCW 48.31B.030(1)(b)(iv), to submit for approval to the Washington State Insurance Commissioner's Office an intercompany agreement with SAM and pertinent affiliates which complies with RCW 48.31B.030(1)(a).**

### **3. Bonds – Investment in Barrier Ridge LLC**

Barrier Ridge LLC is a wholly-owned affiliate of the Company's parent, SAFECO Corporation. Barrier Ridge LLC was formed with \$6,000,000 capital on October 18, 1999. On December 17, 1999, the Company transferred low-grade bonds having a market value of \$162,701,857 (\$172,250.00 par value); accrued interest of \$3,541,577 on the low-grade bonds; and a Federal Home Loan Mortgage Corporation (FHLMC) zero coupon bond having a market value of \$34,531,250 (total of \$200,774,684) to Barrier Ridge LLC in exchange for \$200,000,000 in promissory notes of Barrier Ridge LLC and \$774,684 in cash. The Company realized a loss of \$11,431,578 on the 1999 transfer of the securities to Barrier Ridge LLC.

The FHLMC zero coupon bonds will mature for \$200,000,000 on December 11, 2025, which is the same date that the \$200,000,000 in promissory notes issued by Barrier Ridge LLC will mature. The \$200,000,000 in FHLMC bonds purchased by Barrier Ridge LLC at a cost of \$34,351,250 will pay off the Barrier Ridge LLC notes of \$200,000,000 on December 11, 2025. In the meantime, Barrier Ridge LLC will own \$172,250,000 (par value) in low-grade bonds acquired from the Company and will be entitled to the principal on these bonds as they mature (assuming none of the bonds default). The principal received from the low-grade bonds while held by Barrier Ridge LLC will benefit SAFECO Corporation rather than SAFECO Life, which received a 1% guarantee on the \$200,000,000 Notes (the actual interest rate for 2000 was 8.357%). Many of the low-grade bonds transferred by the Company to Barrier Ridge paid interest rates ranging from 9 to 11 percent.

The four Barrier Ridge LLC promissory notes totaling \$200,000,000 provided to the examiners by the Company, Notes No. 2, 6, 7 and 8, were dated June 7, 2001, subsequent to the December 31, 2000 examination date. Neither the Company, SAFECO Corporation, nor Barrier Ridge LLC were able to provide copies of three of the four notes that were outstanding as of December 31, 2000.

The purchase of the \$200,000,000 in promissory notes was approved by the Company's Finance Committee at its meeting held January 31, 2000; however, the minutes of the meeting refer to an investment in four "CBO Interline Bonds" rather than investments in the promissory notes of Barrier Ridge LLC. The Company's Finance Committee Minutes did not correctly describe the investments or indicate that the investments were being made in an affiliated company for ratification by the Board of Directors, and was not included in the holding company reports filed with the OIC.

The Barrier Ridge LLC promissory notes had an admitted value of \$200,000,000 and the Company admitted \$417,850 in accrued interest on the notes as of December 31, 2000.

**The Company is instructed to comply with the remedies contained in RCW 48.31B.050(3) as the Barrier Ridge LLC transactions were determined to be in violation of the Holding Company Act. The remedies and penalties under the code do not provide for nonadmission of the asset, only cease and desist, avoidance of the transactions, and possible monetary penalties. The transactions with Barrier Ridge LLC were not in compliance with and would not have been approved under RCW 48.31B.030 because of their inability to meet investment statutes for allowable investments and the following sections of the Washington Code:**

- a) RCW 48.05.280 – Requires that the Company keep full and adequate accounts and records of its assets, obligations, transactions and affairs. The Company did not properly disclose the Barrier Ridge LLC transaction in its Finance Committee Minutes and was unable to provide copies of three of the four Barrier Ridge LLC promissory notes that were outstanding as of December 31, 2000.
- b) RCW 48.13.050(1) – Requires that obligations bear fixed interest during each of any three, including the last two, of the five fiscal years next preceding the date of acquisition by the insurer and defines the net earning requirements. The Company's investment in Barrier Ridge LLC promissory notes did not meet the statutory requirements. The Company purchased the promissory notes of Barrier Ridge LLC on December 17, 1999. Barrier Ridge LLC was formed October 18, 1999 and had been in existence only two months at the time the promissory notes were acquired by the Company.
- c) RCW 48.13.340 – Requires that the investment be authorized or approved by its Board of Directors or by a committee charged by the Board of Directors or the Bylaws with the duty of making such investment and that the minutes of any such committee shall be recorded and reports thereof shall be submitted to the Board of Directors for approval or disapproval. The Company's Finance Committee minutes of January 31, 2000 (minutes were ratified by the Company's Board of Directors) reported the investment in four "CBO Interline Bonds" rather than four investments in the promissory notes of Barrier Ridge LLC.

- d) RCW 48.13.350 – Requires that the Company maintain a permanent written record of each investment which shall include the name of the obligor, a description of the security and the record of earnings, the amount invested, the rate of interest, the maturity and yield based upon the purchase price. The Company was unable to provide a permanent written record for the Barrier Ridge LLC promissory notes that contained the required information.
- e) RCW 48.31B.030(1)(a)(i) – Provides that transactions within a holding company system must have terms that are fair and reasonable. The transaction with Barrier Ridge LLC was not fair and reasonable to the Company as Barrier Ridge LLC has the possibility of receiving up to \$172,250,000 (par value) from the maturity of the low-grade bonds it received from the Company between the time the transaction was made in 1999 until the time the promissory notes mature in 2025.

See item No. 1 under ‘SUBSEQUENT EVENTS’, for special consent order No. 95 issued by the Washington State Office of Insurance Commissioner on December 20, 2002.

#### **4. Prohibited Investments in Foreign Securities**

The Company had invested in foreign bonds (excluding Canadian bonds) having an admitted value of \$159,931,609 and admitted accrued interest on those bonds of \$2,230,952 as of December 31, 2000. As of December 31, 2000, the Company transacted business only in the United States and Canada.

The Company made the investment transactions in foreign securities under the belief that the foreign securities were permitted and allowed as miscellaneous assets under RCW 48.13.240. The Washington State Office of Insurance Commissioner (OIC) indicated that investments in foreign securities were limited to those categories described in RCW 48.13.180, which allows for investments in foreign securities in an aggregate amount not exceeding its deposit and reserve requirements for that country.

Starting in 2000, the Company began investing in Euro Dollar Futures (Schedule DB of Annual Statement). During the examination, the Washington State Office of Insurance Commissioner ruled that Euro Dollar Futures were considered to be ineligible foreign investments.

**The Company is instructed to comply with RCW 48.13.290(1) which states, “Any ineligible personal property or securities acquired by an insurer may be required to be disposed of within the time not less than six months specified by order of the commissioner, unless before that time it attains the standard of eligibility.” Under this Examination Order, the Company will be required to dispose of ineligible foreign securities in a time frame as specified under Special Consent Order No. 94. See item No. 2 under “SUBSEQUENT EVENTS” for special consent order No. 94 issued by the Washington State Office of Insurance Commissioner on December 20, 2002.**

#### **5. Bonds – Investment in Principal Protected Equity Linked Trust**

Schedule D of the Company’s 2000 Annual Statement reported an investment in Principal Protected Equity Linked Trust having an admitted value of \$10,198,485, a par value of \$19,018,732, a market value of \$2,194,798, and a cost of \$10,039,508. The Company reported no accrued interest on the

investment in its 2000 Annual Statement. The Company indicated that the \$2,194,798 market value was incorrect and should have been reported as \$10,198,485 and that the \$19,018,732 par value was incorrect and should have been reported as \$11,038,000.

Information provided by the Company indicated that the Principal Protected Equity Linked Trust was purchased from Morgan Stanley & Company as Book-Entry Agent for the security. A November 15, 1999 confirmation of purchase was addressed to SAFECO Asset Management Company, an affiliate, and the confirmation indicated that: "...in connection with your acquisition of the Certificate of Beneficial Interest (Units) we hereby confirm the issuance in your name and recordation upon our register of the Aggregate United Par Amount of Units listed in Appendix A". A unit reinvestment program agreement dated November 15, 1999 indicated that SAFECO Asset Management was the beneficial owner of the security. The security was not included in the securities held by custodial banks. The Company indicated that the security was being held by Morgan Stanley & Company, a broker, as Book-Entry Agent as of December 31, 2000. During the examination, the Company provided a copy of a November 15, 1999 unit investment program agreement with the name of SAFECO Asset Management Company crossed out and the name of SAFECO Life Insurance Company written in; however, the Company did not provide changes in the name for the other documents supporting the ownership of this security.

RCW 48.13.450 defines qualified custodians for the safekeeping of securities and RCW 48.13.450(6) provides that a qualified custodian does not include a broker. The Company's investment in Principal Protected Equity Linked Trust recorded in the name of SAFECO Asset Management Company and held by a broker as Book-Entry Agent did not meet the requirements of RCW 48.12.010 or RCW 48.13.450(6) as of December 31, 2000.

**The Company is instructed to put controls in place to ensure compliance with RCW 48.12.010 which provides that in the determination of the financial condition of any insurer there shall be allowed as an asset only such assets as belong wholly and exclusively to the insurer, and which are registered, recorded, or held under the insurer's name. The \$10,198,485 statement value has been nonadmitted on the financial statements of this report since the security was not properly registered in the Company's name and was improperly held by a broker custodian in violation of RCW 48.13.450.**

#### **6. Common Stock – Investment in Affiliates Improperly Valued**

As of December 31, 2000, D. W. Van Dyke & Co., Inc., was a wholly-owned subsidiary of the Company. Its only asset was an 85% interest of Medical Risk Managers, Inc., with the Company owning the remaining 15% of Medical Risk Managers, Inc. Schedule D, Part 2, Section 2 and Part 6, Section 1 of the Company's 2000 Annual Statement incorrectly reported that the Company owned 5,000 shares of Medical Risk Managers, Inc. As of December 31, 2000, the Company owned 750 shares (15%) and D. W. Van Dyke & Co., Inc., owned 4,250 shares (85%) of Medical Risk Managers, Inc. The Company incorrectly filed with the SVO and reflected on Schedule D, Part 6, Sections 1 and 2 in years 1999 and 2000 information on goodwill or other intangible assets associated with D.W. Van Dyke & Co., Inc., and Medical Risk Managers, Inc. The Annual Statements incorrectly indicated that neither affiliate had any goodwill or other intangible assets.

On August 31, 2001, the SVO assigned a December 31, 2000 value of \$955,745 for the Company's investment in D. W. Van Dyke & Co., Inc., which was \$739,396 less than the \$1,695,141 admitted

value reported in Schedule D, Part 2, Section 2 of the Company's 2000 Annual Statement. On August 31, 2001, the SVO assigned a December 31, 2000 value of \$168,661 for the Company's investment in Medical Risk Managers, Inc., which was \$130,482 less than the \$299,143 admitted value reported in Schedule D, Part 2, Section 2 of the Company's 2000 Annual Statement. The Company incorrectly included goodwill in its valuations. The two adjustments totaling \$869,878 have been reported as a nonadmitted asset in the financial statements of this report.

**The Company is instructed to comply with RCW 48.12.020(1) which does not recognize goodwill in the valuation of a subsidiary pursuant to RCW 48.12.180(3). In addition, the Company is instructed to correctly report the ownership share distribution between affiliates to comply with RCW 48.05.250(1) which requires that the Company file with the OIC a true statement of its financial condition, transactions and affairs.**

#### **7. Short-Term Investment Not Confirmed**

The AIP Commercial Paper reported as having an admitted value of \$1,956,369 in Schedule DA, Part 1 of the Company's 2000 Annual Statement was not confirmed by the custodian, The Chase Manhattan Bank. No confirmation of the asset was made during the examination in spite of written requests by the examiners and telephone requests by the Company's cash management manager. The \$1,956,369 admitted value of the AIP Commercial Paper has been nonadmitted on the financial statements of this report.

**The Company is instructed to comply with RCW 48.12.010 that provides in the determination of the financial condition of any insurer there shall be allowed as an asset only such assets as belong wholly and exclusively to the insurer, and which are registered, recorded, or held under the insurer's name.**

#### **8. Guaranty Funds on Deposit Not Allowed as Future Offset to Taxes**

Included in the \$1,844,385 asset for guaranty funds receivable or on deposit in the Company's 2000 Annual Statement was \$266,439 in credits for the state of Illinois which the Company will not be allowed to use as future offsets. The \$266,439 in guaranty funds has been nonadmitted on the financial statement of this report.

**The Company is instructed to comply with RCW 48.05.250(1) that requires the Company to file a true statement of its financial condition, transactions and affairs with the Commissioner of Insurance.**

#### **9. Accrued Interest on Derivative Instruments Not Supported by Company**

Exhibit 2 of the Company's 2000 Annual Statement reported \$1,458,607 in accrued interest on derivative instruments. The Company was able to provide support for only \$1,309,688 in accrued interest on derivative instruments. The \$148,919 difference in accrued interest on derivatives has been nonadmitted on the financial statements of this report.

**The Company is instructed to comply with RCW 48.05.250(1) which provides that the Company file with the Commissioner of Insurance a true statement of its financial condition, transactions**

and affairs and with RCW 48.05.280 which provides that every insurer shall keep full and adequate accounts and records of its assets, obligations, transactions and affairs.

#### **10. Separate Accounts Statement–Mutual Fund Accounts Not in Company’s Name**

The direct confirmations received on mutual funds during the examination and transaction reports supporting the INVESCO VIF – Real Estate Opportunity Fund, Federated Utility Fund II, Federated High Income Bond Fund II, and Federated International Equity Fund II were in the name of SAFECO Mutual Funds rather than SAFECO Life Insurance Company. The Company had the account names on each of the four mutual funds changed to the Company’s name during the examination. The four mutual funds, having a December 31, 2000 admitted value of \$31,106,280, were in violation of RCW 48.12.010. The value of the four mutual funds has been nonadmitted on the financial statements in this report.

**The Company is instructed to comply with RCW 48.12.010 which provides that in the determination of the financial condition of any insurer there shall be allowed as an asset only such assets as belong wholly and exclusively to the insurer, which are registered, recorded, or held under the insurer’s name.**

#### **11. Error in Liability for Amounts Held for Agents’ Account**

The Company’s 2000 Annual Statement reported a \$51,228 liability for Amounts Held for Agents’ Account, in error. The balance included a \$250,000 reduction in a liability made by the Company in its attempt to reverse a previous entry. The correct balance should have been reported as \$301,228 as of December 31, 2000. An adjustment to increase the liability by \$250,000 has been made on the financial statements of this report.

**The Company is instructed to comply with RCW 48.05.250(1) that requires the Company to file with the Commissioner of Insurance a true statement of its financial condition, transactions and affairs.**

#### **12. Unreconciled Balance in Account Included in Aggregate Write-Ins for Liabilities**

The Aggregate Write-Ins for Liabilities account had a \$459,926 unreconciled receivable offset component as of December 31, 2000. This variance was never resolved and has been written off by the Company as an expense in the year 2002. Therefore, the offset has been disallowed and the liability for Aggregate Write-Ins for Liabilities has been increased by \$459,926 and Surplus has been decreased by the same amount on the financial statements of this report.

**The Company is instructed to comply with RCW 48.05.250(1) that requires the Company to file with the Commissioner of Insurance a true statement of its financial condition, transactions and affairs.**

#### **13. Bonds – Amortization**

The Company was requested to provide bond amortization schedules for selected securities. The individual amortization schedules provided by the Company did not agree with the amortization

reported in Schedule D of the Company's 2000 Annual Statement. For example, Schedule D, Part 1 of the Company's 2000 Annual Statement reported:

- a) Cox Communications (CUSIP 224044-AX-5) having a par value of \$19,182,000 acquired as having a cost of \$9,999,768 and a December 31, 2000 book value of \$10,217,308. The Company reported a \$69,630 increase in amortization in Schedule D, Part 1 rather than the correct increase of \$217,540 resulting in an understatement of \$147,910 in amortization.
- b) A \$150,529 increase in amortization for Specialty Retailers (CUSIP 847514-AN-6). The correct increase in amortization for 2000 should have been \$2,619 rather than the \$150,529 reported resulting in an overstatement of \$147,910 in amortization. The errors in the amortization of Cox Communications and Specialty Retailers offset each other.
- c) Schedule D, Part 1 of the Company's 2000 Annual Statement reported Nabors Industries (CUSIP 629568-AC-0) with a cost of \$8,499,000 and a par value of \$10,000,000. The amortization schedule presented by the Company reported that the security had a par value of \$15,000,000 and was purchased July 28, 2000 at a cost of \$9,157,500. The Company's amortization schedule reported no amortization as of December 31, 2000 while Schedule D, Part 1 reported a \$101,102 increase in amortization.

**The Company is instructed to correct and maintain amortization schedules on individual investments that will tie to the amortization reported in Schedule D and is instructed to comply with RCW 48.12.170(1)(b) which provides that bonds or evidences of debt having a fixed term and rate purchased above or below par shall be valued on the basis of the purchase price adjusted so as to bring the value to par at the earliest date callable at par or maturing at par or in lieu of such method, according to such accepted method of valuation as is approved by the commissioner.**

#### **14. Custodial Responsibilities**

The confirmation of principal pay down securities received directly from Chase Manhattan Bank of New York (Chase) as of December 31, 2000, reported par values as of the time the securities were deposited with the bank rather than the amortized par values as of December 31, 2000. Since the information supplied by Chase could not be reconciled to the Company's records, the Company was asked to provide copies of the custodial statements listing the bank's amortized par values as of December 31, 2000. The Company indicated that the monthly statements prepared by Chase were received in electronic form and that the Company was unable to make copies as the information was encoded. Chase indicated that it was unable to provide listings of securities with the December 31, 2000 amortized par values.

The examination team informed the Company that the December 31, 2000 amortized par values must be reported in response to the confirmations. Direct confirmations listing the amortized par values of the securities as of December 31, 2000 were eventually prepared and received from Chase. The Company must require that its custodian(s) be able to produce accurate, reliable listings of all securities at amortized par value for purposes of accurate reconciliation and reporting.

**The Company is instructed to comply with RCW 48.05.280 which provides that the Company keep full and adequate accounts and records of its assets, obligations, transactions and affairs.**

#### **15. Bonds - Maturity Date and Interest Rate Errors**

Numerous securities listed in Schedule D, Part 1 of the Company's 2000 Annual Statement had maturity dates that did not agree with the maturity dates listed on the confirmations received directly from the custodial banks. The Company was asked to research the 31 most significant errors and it was determined that the Company's records were wrong in 14 instances and that the custodial banks' records were wrong in 17 instances. Incorrect maturity dates reported by the Company affect the amount of amortization computed by the Company and affect the data recorded by the Company in Schedule D, Part 1 of its Annual Statements. The Company must cross check the maturity dates listed in Schedule D, Part 1 to the maturity dates reported by the custodial banks and must ensure correction of the erroneous information on a timely basis.

Schedule D, Part 1 of the Company's 2000 Separate Account Annual Statement had maturity dates and interest rates that did not agree with the maturity dates listed on the confirmations received directly from the custodial bank. The Company either provided support for the maturity dates and interest rates it used in Schedule D or made the necessary corrections during the examination. One of the corrections made by the Company was to Prudential Home Mortgage Securities (CUSIP 74434T-RY-5) listed in Schedule D, Part 1 as having a June 25, 2008 maturity when in fact the security had an August 25, 2003 maturity date.

**The Company is instructed to reconcile Company records with bank custodial records to accurately reflect amortized values in compliance with RCW 48.12.170, Valuation of Bonds, RCW 48.05.250(1) requiring the Company to file a true statement of its financial condition, transactions and affairs, and RCW 48.05.280 which requires the Company to keep full and adequate accounts and records of its assets, obligations, transactions and affairs.**

#### **16. Errors in Annual Statements**

Review of the Company's Annual Statements for the period under examination disclosed numerous errors and/or omissions. RCW 48.05.250(1) states, "Each authorized insurer shall annually, before the first day of March, file with the commissioner a true statement of its financial condition, transactions and affairs as of the thirty-first day of December preceding. The statement forms shall be in general form and context as approved by the National Association of Insurance Commissioners for the kinds of insurance to be reported upon, and as supplemented for additional information required by this code and by the commissioner."

**The Company is instructed to review and continue its efforts to substantially strengthen controls to comply with RCW 48.05.250(1) which requires the Company to file a true statement of its financial condition, transactions and affairs. The results of the examination disclosed the following errors in the Company's Annual Statements:**

- a) Schedule E, Part 2 (Special Deposits) of the Company's 2000 Annual Statement reported statutory deposits having a total par value of \$2,935,000. The \$2,935,000 included \$1,125,000



in statutory deposits being held by the state of Washington. Both totals were incorrect as Schedule E, Part 2 reported securities having a total par value of \$4,445,000 rather than \$2,935,000 and reported securities having a total par value of \$2,635,000 rather than \$1,125,000 as being held by the state of Washington.

The \$1,510,000 error in the totals reported in Schedule E, Part 2 represented the par value of the securities being held by the state of Washington in the name of SAFECO Life. The securities were listed in Schedule E, Part 2; however, the Company failed to include the par value of these securities in the totals. The securities having a par value of \$1,125,000 represented only those securities held by the state of Washington in the name of Empire Life Insurance Company (Empire merged into the Company effective January 1, 2000). On March 27, 2002, the Company withdrew the \$1,125,000 in securities and transferred them to an account in SAFECO Life's name.

- b) Schedule E, Part 2 (Special Deposits) of the Company's 2000 Annual Statement reported a statutory deposit having a par value of \$200,000 being held by the state of Arkansas. The deposit, originally in the name of Empire Life Insurance Company, was released to the Company on December 10, 2000 and should not have been included in the 2000 Annual Statement.
- c) The Securities Valuation Office of the NAIC (SVO) classified MCI Capital (CUSIP 55267Y-20-6) as an industrial bond (Group Code 55). The Company incorrectly classified the security as a preferred stock in Schedule D, Part 2, Section 2 of its 2000 Annual Statement.

The SVO classified IES Utilities (CUSIP 44949R-50-8) as preferred public utility stock while the Company incorrectly listed the security as a preferred industrial and miscellaneous stock. The custodial bank incorrectly classified the security as common stock.

- d) Schedule D, Part 6, Section 1 of the Company's 2000 Annual Statement (valuation of shares of subsidiaries) incorrectly reported that the Company owned 2,000 shares of SAFECO National Life Insurance Company. The Company actually owned 20,000 shares of SAFECO National Life Insurance Company as of December 31, 2000.
- e) Schedule D, Part 1 of the Company's 2000 Annual Statement reported \$130,661 in negative accrued interest for Cox Communications (CUSIP 224044-AX-5) as of December 31, 2000. The Company indicated that the \$130,661 in negative accrued interest was due to a misapplication of an accrual adjustment that should have been offset to amortization.
- f) Schedule D, Part 4 of the Company's 2000 Annual Statement reported write downs or basic adjustments for Rite Aid Corporation notes of \$1,412,713; \$2,500,072; \$1,251,684 and \$1,250,342 for CUSIP 767754-AH-7; \$1,456,242 for CUSIP 767754-AM-6; and \$2,447,773 for CUSIP 767754-AR-5. The Company indicated that two of the write downs were applied to incorrect CUSIP numbers and that the write down of \$2,500,072 should have been applied to CUSIP 767754-AM-6 and that the write down of \$1,251,684 should have been applied to CUSIP 767754-AR-5.

- g) Schedule D, Part 2, Section 2 of the Company's 2000 Annual Statement classified the Company's investments in SAFECO Equity Fund, SAFECO Growth Fund, SAFECO Income Fund and SAFECO Money Market Fund having an aggregate admitted value of \$1,655,688 as industrial and miscellaneous common stocks. The investments in the shares of affiliates should have been classified as investments in "Parent, Subsidiaries and Affiliates."

The number of shares reported in Schedule D, Part 2, Section 2 of the Company's 2000 Annual Statement for SAFECO Equity Fund, SAFECO Growth Fund, SAFECO Money Market Fund, SAFECO Income Fund, SAFECO Intermediate U. S. Treasury Fund and SAFECO Northwest Fund were not reconcilable to the number of shares reported on the confirmations received directly from the various funds. The Company indicated that the numbers of shares reported on the confirmations were correct and that the numbers of shares reported in Schedule D were incorrect. The errors reported in Schedule D ranged from a shortage of 2,506 shares for the SAFECO Equity Fund to an overstatement of 832 shares for the SAFECO Money Market Fund.

The number of shares reported in Schedule D, Part 2, Section 2 of the Company's 2000 Separate Accounts Annual Statement for the Scudder Money Market Portfolio were not reconcilable to the number of shares reported on the confirmation received directly from the mutual fund. The Company reported 139 shares less than the number of shares on the confirmation.

The number of shares reported in Schedule D, Part 2, Section 2 of the Company's 2000 Separate Accounts Annual Statement for SAFECO Resource Series Trust Equity Portfolio and SAFECO Resource Series Trust Money Market Portfolio were not reconcilable to the number of shares reported on the confirmations received from the affiliated trusts. The unit manager for SAFECO Trusts indicated that an extensive search did not reveal why the number of shares in Schedule D were understated 11,525 shares for the Equity Portfolio and understated 4,288 shares for the Money Market Portfolio.

- h) The CUSIP numbers for the SAFECO Resource Series Trust Growth Opportunities Portfolio and the SAFECO Resource Series Trust Northwest Portfolio were incorrect in the Schedule D, Part 2, Section 2 of the Company's 2000 Separate Account Annual Statement.
- i) Schedule D, Part 2, Section 2 of the Company's 2000 Separate Accounts Annual Statement reported the correct number of shares and the correct market rates for the five Dreyfus funds; however, the names of the five Dreyfus Funds listed in Schedule D, Part 2, Section 2 of the Company's 2000 Annual Statement did not match the shares reported or the market rates used. The errors did not result in a surplus change.
- j) Schedule D, Part 2, Section 2 of the Company's 2000 Separate Accounts Annual Statement, showing all common stocks owned, reported three Composite mutual funds having no shares owned as of December 31, 2000 and that the Company had received \$39,537,563 in dividends during 2000. The 1999 Separate Accounts Annual Statement reported that the Company owned Composite Mutual Fund shares as of December 31, 1999. The Company did not correctly report the shares owned December 31, 1999 and sold in 2000 in Schedule D, Part 4 of the 2000 Annual Statement. The Company did not report the shares acquired in 2000 and sold

in 2000 in Schedule D, Part 5 of the 2000 Annual Statement. The Composite Mutual Fund shares and the shares of other funds acquired and redeemed during the same year were not reported in Schedule D, Part 5 of the Company's 1996, 1997, 1998, 1999 or 2000 Separate Account Annual Statements. The \$39,537,563 in dividends received on Composite Mutual Fund shares no longer owned should not have been reported in Schedule D, Part 2, Section 2 but included in Schedule D, Parts 4 and 5.

Schedule D, Part 4 of the Company's Separate Accounts Annual Statements for 1996, 1997, 1998, 1999 and 2000 reported no dividends on mutual fund shares sold during the year (column 14). Dividends received on mutual funds shares reported as being sold in Schedule D, Part 4 during the year were improperly included in Schedule D, Part 2, Section 2 as dividends on common stock owned at year-end.

- k) Schedule DA, Part 1 of the Company's 2000 Annual Statement incorrectly reported a \$6,635,000 short-term investment in SAFECO Property and Casualty, a non-existent company. The investment represented notes receivable from American States Insurance Company, an affiliate.
- l) The 1999 transaction between the Company and Barrier Ridge LLC was not listed in Schedule Y of the Company's 1999 Annual Statement. The Company's \$200,000,000 investment in Barrier Ridge LLC was improperly classified in Schedule D, Part 1 of the Company's 1999 and 2000 Annual Statements as an investment in Industrial and Miscellaneous bonds rather than as an investment in a Parent, Subsidiary or Affiliate.
- m) As of December 31, 2000, the Company's Separate Account Annual Statement reported investments in six portfolios offered by SAFECO Resource Series Trust having an admitted value of \$842,493,595. The Company's Regular Annual Statement reported an investment in one portfolio offered by SAFECO Resource Series Trust having an admitted value of \$5,340,000. Purchases and sales of SAFECO Resource Series Trust made during the five year period under review were not reported in Schedule Y, Column 6 of the Company's Regular Annual Statement. SAFECO Resource Series Trust was not reported as an affiliate on Schedule Y, Part 1 of the Company's 1996, 1997, 1998, 1999 and 2000 Regular Annual Statements.
- n) The Company did not list a number of insurance agencies in Schedule Y, Part 1, which conducted the business of insurance as listed under "AFFILIATED COMPANIES". The Company failed to include in its organizational chart SAFECO UK Limited and numerous insurance agencies which were owned either directly by SAFECO Corporation or by an affiliate. The NAIC Annual Statement Instructions indicate for Schedule Y, Part 1, that a chart or listing presenting the identities of and interrelationships between the parent, all affiliated insurers and other affiliates should be attached to the Annual Statement.

#### **17. Incomplete and Incorrect Finance Committee Minutes**

Quarterly minutes of the Company's Finance Committee covering the period from January 1, 1996 through December 31, 2000 were incomplete as the Company was unable to locate the August 5, 1996 minutes covering the investment transactions for the second quarter of 1996. The minutes of the

Company's Finance Committee reported the profits and losses on the transactions; however, there were instances in which the profits and losses reported in the minutes did not agree with the gains and losses in Schedule D, Parts 3, 4 and 5.

During 1999, American States Insurance Company, American States Preferred Insurance Company and American Economy Insurance Company, affiliates of the Company, acquired bonds from the Company having a book value of \$93,517,776 for a consideration of \$90,875,356 resulting in a \$2,642,420 loss for SAFECO Life. During 2000, American States Insurance Company, an affiliate, transferred bonds having a book value of \$10,664,722 to the Company for a consideration of \$10,331,622 resulting in a \$333,100 loss to American States Insurance Company. Securities that were involved in intercompany purchases or transfers were not recorded in the Company's Finance Committee minutes.

**The Company is instructed to comply with RCW 48.13.340 which provides that no investment, sale or exchange shall be made by any domestic company unless authorized or approved by its Board of Directors or by a committee charged by the Board of Directors or the Bylaws with the duty of making such investment, sale or exchange and with RCW 48.05.280 which provides that every insurer shall keep full and adequate accounts and records of its assets, obligations, transactions and affairs.**

## **COMMENTS AND RECOMMENDATIONS**

The examiners developed the following comments and recommendations:

### **1. Investment Guidelines**

The investment guidelines adopted by the Company on May 1, 2000 covered both the SAFECO Group of life companies and the SAFECO Group of property and casualty companies on a consolidated basis. Both the 2000 and 2001 investment guidelines had paragraphs that were incorrectly numbered or incomplete.

The Company adopted new investment guidelines effective January 1, 2002 that were correctly numbered; however, these guidelines were also on a consolidated basis for the life and property/casualty companies in the SAFECO Group. Before the January 1, 2002 investment guidelines were adopted, it was suggested to the Company that they be prepared on an individual company basis rather than on a consolidated basis. The consolidated guidelines adopted in 2002 currently cover the SAFECO Group of companies that are domiciled in a number of different states and have different limitations for various assets. An example of the investment limitations on an individual company basis are contained in RCW 48.13.180 and RCW 48.13.273.

**It is recommended the Company adopt individual investment guidelines that cover the investment requirements in the Washington Insurance Code.**

## **2. Custodial Agreements**

As of December 31, 2000, the Company's securities were held by The Chase Manhattan Bank. The Company indicated that the securities held by The Chase Manhattan Bank were being held under an October 26, 1990 custodial agreement with the United States Trust Company of New York. The 1990 agreement had no provision for a successor. The Company had no documentation indicating that the 1990 agreement with the United States Trust Company of New York covered the securities held by The Chase Manhattan Bank. During the examination, the Company secured an October 11, 2001 letter from The Chase Manhattan Bank which indicated that effective September 1, 1995 the United States Trust Company of New York merged with and into The Chase Manhattan Bank, N.A., which in turn merged with Chemical Bank and changed its name to The Chase Manhattan Bank and that by virtue of these mergers, The Chase Manhattan Bank has succeeded, by operation of law, to the rights, duties, and obligations of the United States Trust Company of New York with respect to the October 26, 1990 custodial agreement.

**It is recommended the Company review custodial agreements to ensure the inclusion of a provision which provides for legal succession of rights and responsibilities under the original custodial agreement.**

## **HISTORY**

SAFECO Life Insurance Company was incorporated January 23, 1957 under the laws of the state of Washington and began active operations on April 5, 1957.

On December 31, 1997, the Company acquired WM Life Insurance Company and its wholly-owned subsidiary Empire Life Insurance Company at a cost of \$105,817,000.

WM Life Insurance Company merged with the Company on July 1, 1998 under the statutory merger method resulting in no issuance of stock.

Empire Life Insurance Company merged with the Company on January 1, 2000 under the statutory merger method resulting in no issuance of stock.

The above purchase and mergers were approved by the Washington State Office of Insurance Commissioner.

## **CAPITAL AND SURPLUS**

As of December 31, 2000, the authorized capital stock of the Company consisted of 20,000 shares of common stock with a par value of \$250 per share, of which 20,000 shares were issued and outstanding. The following schedule summarizes the changes in the Company's capital and paid in surplus since the date of the last examination:

## **CAPITAL AND SURPLUS, Cont'd**

<u>Date</u>	<u>Authorized Shares</u>	<u>Shares Outstanding</u>	<u>Capital Paid-Up</u>	<u>Paid In and Contributed Surplus</u>
December 31, 1995	20,000	20,000	\$5,000,000	\$ 85,000,000
December 31, 2000	20,000	20,000	5,000,000	161,758,622

On March 31, 2000, the Company received \$76,758,622 in paid in and contributed surplus from SAFECO Corporation, its parent. The paid in and contributed surplus consisted of 2,500,000 shares of the common stock of American States Life Insurance Company. As of December 31, 2000, American States Life Insurance Company was a wholly-owned subsidiary of the Company. The Company received \$20,600,000 in dividends from American States Life Insurance Company during 2000.

### **Dividends Paid to Shareholder**

Dividends paid by the Company during the five-year period covered by this examination to SAFECO Corporation, the parent company, were as follows:

<u>Year</u>	<u>Dividends Paid To Shareholder</u>
1996	\$ 4,000,000
1997	16,000,000
1998	90,000,000
1999	0
2000	48,950,000

### **Dividends Paid to Policyholders**

Dividends paid by the Company during the five-year period covered by this examination to policyholders were as follows:

<u>Year</u>	<u>Dividends Paid To Policyholders</u>
1996	\$11,050
1997	10,792
1998	12,588
1999	16,125
2000	5,692

## **MANAGEMENT AND CONTROL**

### **Shareholder**

The Company's outstanding shares were 100% owned by SAFECO Corporation ("the Corporation"), an insurance holding company incorporated under the laws of the state of Washington.

The Corporation, directly or indirectly, owned the stocks of operating subsidiaries engaged in various phases of the insurance business and other financially related lines of business.

### **Board of Directors**

The affairs of the Company were managed and its corporate powers were exercised by the authority of a nine member Board of Directors. The membership of the Board as of December 31, 2000, together with the city and state of residence and principal business or professional affiliation of each director, were as follows:

<u>Name/Address</u>	<u>Position(s)/Principal Affiliation(s)</u>
Roger Harry Eigsti Seattle, Washington	Chairman and Chief Executive Officer SAFECO Corporation
Boh Andrew Dickey Woodinville, Washington	President and Chief Operating Officer SAFECO Corporation
Randall Howard Talbot Medina, Washington	President SAFECO Life Insurance Company
Donald Shelton Chapman Woodinville, Washington	Senior Vice President, Chief Operating Officer SAFECO Insurance Company of America (Commercial Insurance)
Dale Ellis Lauer Woodinville, Washington	Senior Vice President SAFECO Insurance Company of America (American States Business Insurance)
William Thomas Lebo Lake Forest Park, Washington	Executive Vice President SAFECO Insurance Company of America
Rodney Allen Pierson Redmond, Washington	Senior Vice President, Chief Financial Officer, Secretary SAFECO Corporation
James Walter Ruddy Mercer Island, Washington	Senior Vice President, General Counsel SAFECO Corporation
Ronald Lee Spaulding Mill Creek, Washington	Treasurer and Chief Investment Officer SAFECO Corporation

During January 2001, Roger Harry Eigsti and Boh Andrew Dickey resigned from the Board of Directors and Roger Floyd Harbin and Michael Sean McGavick were elected to the Board of Directors.

### **Officers**

Officers of the Company as of December 31, 2000 were:

<u>Name</u>	<u>Position</u>
Randall Howard Talbot	President
Ronald Lee Spaulding	Treasurer and Vice President
Rodney Allen Pierson	Secretary and Vice President
Michael John Kinzer	Actuary and Vice President
Scott Lee Bartholomaeus	Vice President
Leslie June Brandli	Vice President
Frank Gregory Clarke	Vice President
Stephen Dwight Collier	Vice President
Jennifer Victoria Davies	Vice President
Roger Floyd Harbin	Vice President
Michele Marie Kemper	Vice President
Homer Paul Lowber	Vice President
Steven Allen Manuel	Vice President
Patrick Bryan McCormick	Vice President
Michael Ray McLean	Vice President
Kimberly Elaine McSheridan	Vice President
Troy Olson-Blair	Vice President
George Christopher Pagos	Vice President
James Dwyer Pirak	Vice President
Craig James Schmidt	Vice President
Elizabeth Anne Sisti	Vice President
Paul Alexander Stevenson	Vice President
Malcolm Scott Taylor	Vice President
Sue Ellen Taylor	Vice President
Michael Rion Tucker	Vice President
James Lester Wilson	Vice President

### **Finance Committee**

The Company's Finance Committee consisted of the following members as of December 31, 2000:

Roger Harry Eigsti – Chairman  
 Boh Andrew Dickey  
 Rodney Allen Pierson  
 Ronald Lee Spaulding



During January 2001, Roger Harry Eigsti and Boh Andrew Dickey resigned from the Finance Committee and Michael Sean McGavick was appointed as a member of the Finance Committee. The number of members on the Finance Committee was reduced from four to three members in 2001.

## **CONFLICT OF INTEREST**

The Company had an operating procedure for disclosing conflicts of interest to the Board of Directors. Statements are circulated among the directors, officers and key employees every year as set forth in the Company's Policy of Ethical Standards, Conflicts of Interest and Compliance with Laws. The Company had a procedure for obtaining disclosure statements from new appointees during the interim.

A review of the completed statements disclosed that the directors, officers and key employees reported no conflicts of interest as of December 31, 2000.

## **AFFILIATED COMPANIES**

The Company was a wholly-owned subsidiary of SAFECO Corporation, the ultimate controlling person. As a member of an Insurance Holding Company System, registration statements were required to be filed in accordance with RCW 48.31B.025 and WAC 284-18-300. SAFECO Corporation filed the registration statements for each year under examination on behalf of the Company, its parent company, and its affiliated companies.

The following chart was taken from the SAFECO Corporation Organizational and Entity Chart:

SAFECO Corporation	100% Publicly Owned
SAFECO Financial Products, Inc.	100% SAFECO Corporation
SAFECO Insurance Company of Oregon	100% SAFECO Corporation
General America Corporation	100% SAFECO Corporation
Talbot Financial Corporation	100% General America Corporation
F. B. Beattie & Co., Inc.	100% General America Corporation
SAFECO Investment Services, Inc.	100% General America Corporation
SAFECO Select Insurance Services, Inc.	100% General America Corporation
R. F. Bailey Holding Limited	100% General America Corporation
General America Corporation of Texas – Attorney in Fact for:	100% General America Corporation
SAFECO Lloyds Insurance Company	Attorney in Fact
American States Lloyds Insurance Company	Attorney in Fact
First National Insurance Company of America	100% SAFECO Corporation
SAFECO Insurance Company of America	100% SAFECO Corporation
SAFECO Management Corporation	100% SAFECO Insurance Company of America
SAFECO Surplus Lines Insurance Company	100% SAFECO Insurance Company of America
Emerald City Insurance Agency, Inc.	100% SAFECO Insurance Company of America
SAFECO National Insurance Company (Missouri)	100% SAFECO Corporation
General Insurance Company of America	100% SAFECO Corporation
SAFECO Insurance Company of Pennsylvania	100% General Insurance Company of America
SAFECO Insurance Company of Illinois	100% SAFECO Corporation
Insurance Company of Illinois	100% SAFECO Insurance Company of Illinois
American States Insurance Company (Indiana)	100% SAFECO Corporation
American Economy Insurance Company (Indiana)	100% SAFECO Corporation

## **AFFILIATED COMPANIES, Cont'd**

American States Insurance Company of Texas	100% American Economy Insurance Company
American States Preferred Insurance Company (Indiana)	100% SAFECO Corporation
SAFECO Credit Company Inc.	100% SAFECO Corporation
SAFECO Properties, Inc.	100% SAFECO Corporation
Winmar Company, Inc.	100% SAFECO Properties, Inc.
SAFECARE Company, Inc.	100% SAFECO Properties, Inc.
SAFECO Life Insurance Company	100% SAFECO Corporation
SAFECO National Life Insurance Company	100% SAFECO Life Insurance Company
American States Life Insurance Company	100% SAFECO Life Insurance Company
First SAFECO National Life Insurance Company of New York	100% SAFECO Life Insurance Company
D. W. Van Dyke & Co., Inc.	100% SAFECO Life Insurance Company
Medical Risk Managers, Inc.	15% SAFECO Life Insurance Company 85% D. W. Van Dyke & Co., Inc.
SAFECO Asset Management Company	100% SAFECO Corporation
Barrier Ridge LLC	100% SAFECO Corporation
SAFECO Services Corporation	100% SAFECO Corporation
SAFECO Securities, Inc.	100% SAFECO Corporation
SAFECO eCommerce, Inc.	100% SAFECO Corporation
SAFECO Trust Company	100% SAFECO Corporation
SAFECO UK Limited	100% SAFECO Corporation
SAFECO Administrative Services, Inc.	100% SAFECO Corporation
SAFECO Assigned Benefits Service Company	100% SAFECO Corporation

The Company failed to include in its organizational chart SAFECO UK Limited and numerous insurance agencies which were owned either directly by SAFECO Corporation or by an affiliate. The NAIC Annual Statement Instructions indicate for Schedule Y, Part 1, that a chart or listing presenting the identities of and interrelationships between the parent, all affiliated insurers and other affiliates should be attached to the Annual Statement. RCW 48.01.050 defined an insurer as every person engaged in the business of making contracts of insurance. The Company did not list the following insurance agencies in Schedule Y, Part 1 (shown below with the parent company relationship):

SAFECO Insurance Company of America  
Emerald City Insurance Agency, Inc.  
Puget Structured Benefit Agency, Inc.  
SAFECO Select Insurance Services, Inc.  
Pilot Insurance Services, Inc.  
Talbot Agency, Inc.  
Talbot Financial Services, Inc.  
Talbot Insurance Agency of Alabama, Inc.  
Talbot Insurance Agency of Texas, Inc.  
Talbot Agency of Texas, Inc.

## **AFFILIATED COMPANIES, Cont'd**

General America Corporation  
F. B. Beattie & Company, Inc.  
F. B. Beattie Insurance Services, Inc.  
R. F. Bailey Holding Limited  
R. F. Bailey (Underwriting Services) Limited  
SAFECO Life Insurance Company  
D. W. Van Dyke & Company, Inc.  
Medical Risk Managers, Inc.

## **CORPORATE RECORDS**

### **Minutes**

The minutes of the Shareholder, Board of Directors, and Finance Committee meetings for the period covered under examination were reviewed. Investments were reviewed by the Finance Committee and the Finance Committee minutes were ratified by the Board of Directors; however, the minutes for a quarterly Finance Committee meeting held August 5, 1996 were not located by the Company during the examination.

Minutes reviewed indicated that the meetings were well attended and were in sufficient detail and substance to demonstrate that the Board of Directors was actively involved in the administration of the Company's affairs.

### **Contracts/Service Agreements**

The following agreements were in-force as of December 31, 2000:

1. Intercompany Tax Allocation Agreement dated August 1, 1990. A consolidated return was filed by SAFECO Corporation with the companies included in Schedule Y of the Annual Statement in which there was an 80% or more ownership, except for American States Life Insurance Company. The allocation was based upon separate return calculations with current credit for net losses as such losses offset taxable income of other members of the consolidated group. Intercompany tax balances were to have been settled quarterly.
2. Expense Sharing Agreement dated November 3, 1983. The Agreement covers payroll, use of real property, and miscellaneous expenses for sixteen stock companies within the SAFECO Group, which includes the six Washington domestic insurance companies. All of the companies are 100%-owned direct or indirect subsidiaries of SAFECO Corporation, the ultimate controlling person in the SAFECO holding company system.
3. A Lease Agreement, expiring in 2010, between the Company and General America Corporation for real estate. The lease provided at a minimum, an annual rental commitment of \$2,516,200 and

provided for an escalation limit of 5% per year, based on the consumer price index. The total minimum lease obligation for the life of the lease was \$24,529,500 as of December 31, 2000.

4. A Short-Term Borrowing Agreement dated October 27, 1997 between the Company, as lender, and SAFECO Credit Company, Inc., as borrower.
5. Amended and Restated Loan Agreements dated January 5, 1998, between SAFECO Tax-Exempt Bond Trust, SAFECO Taxable Bond Trust, SAFECO Common Stock Trust, SAFECO Money Market Trust, SAFECO Resource Series Trust and SAFECO Managed Bond Trust.
6. Administrative Services Agreement dated November 1, 1998 between the Company and First SAFECO National Life Insurance Company of New York whereby the Company agreed to perform administrative and special services for its wholly-owned subsidiary. A copy of the agreement was filed with the state of New York Insurance Department.
7. The Company and twenty other affiliated companies in the SAFECO Group were named in a November 15, 2000 Intercompany Short-Term Borrowing Agreement.

Intercompany Agreements should be used to document recurring transaction patterns between or among the SAFECO Group member companies. RCW 48.31B.030(1)(a)(iv), requires that records are to "...clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees..." An extensive volume of investment transactions were conducted between the SAFECO insurance companies and SAFECO Asset Management Company, but there was no intercompany agreement specifying the parties' rights, duties and compensation. All such agreements are required to be filed and approved by OIC. See item 2 under the "INSTRUCTIONS" portion of this Examination Report.

### **FIDELITY BONDS AND OTHER INSURANCE**

The Company's fidelity insurance was extended to the Company and its affiliated companies through a Financial Institution Bond issued to SAFECO Corporation, the Company's parent, which provided coverage up to \$3,000,000 aggregate with no deductible. The affiliated companies carried excess insurance which provided an additional amount of coverage in layers through several carriers. The minimum amount of fidelity insurance coverage recommended by the NAIC for an insurance company of this size was \$4,000,000 to \$4,500,000. The minimum amount was met with the Financial Institution Bond and the excess insurance.

The Company was a named insured on various insurance policies issued to its ultimate parent, SAFECO Corporation, that provided protection against certain property and liability losses. Policies providing property coverage for buildings and contents, comprehensive commercial general liability and automobile bodily injury and property damage coverage were in effect during the period covered by this examination.

The Company was a named insured on a Directors and Officers Liability Policy with an authorized insurance carrier. Errors and Omissions coverage was also provided under this policy.

## **OFFICERS', EMPLOYEES' AND AGENTS' WELFARE AND PENSION PLANS**

The employees of the SAFECO Group of property/casualty and life companies were treated as employees of SAFECO Insurance Company of America. The salaries and benefits paid or accrued to these employees were allocated and prorated to the various companies in the Group based on the intercompany pooling agreement and other intercompany arrangements.

The SAFECO Group had the following benefit plans available to officers, employees and their dependents: Group Life Insurance, Accidental Death and Dismemberment, Long-term Disability, Medical and Dental. The SAFECO Group contributes to the Life, Medical and Dental plans.

The SAFECO Group had the following retirement and profit sharing plans:

1. **Cash Balance Plan** – A defined contribution plan established during 1989. The plan provided an annual credit to each employee's account, regardless of profitability of the SAFECO Group. The amount was 3% of eligible compensation paid each year to the participants. The participant's balances were credited with interest at a rate of 5%.
2. **Profit Sharing Bonus** – A cash bonus was paid to the salaried employees who had completed one calendar year of service. Each year 10% of the "adjusted underwriting profit" of the SAFECO Group earned during the previous year was allocated to the profit sharing bonus plan. A cash bonus was then paid to the eligible employees based on a percentage of the previous year's base salary. An employee with three or more calendar years of service could receive a maximum cash bonus of 10% of his or her previous year's salary.
3. **Profit Sharing Retirement Plan** – A defined contribution plan where contributions are based on the SAFECO Group's profit, 5% of net profit, before taxes and stockholder's dividends and after subtracting an amount credited to the Cash Balance Plan. The maximum contribution to the trust shall not exceed 12% of eligible compensation paid each year to the participants.
4. **Employees' Savings Plan** – A defined contribution plan was established during 1967. The plan was available to an employee after 12 calendar months of service. An employee could save up to 6% of basic salary. The companies contributed an amount equal to two-thirds of the employee's deduction.

SAFECO Corporation had a stock option plan for executives and key employees. The stock was issued in SAFECO Corporation. In addition, two non-qualified benefit plans were established during 1989 for the companies' contributions to the Profit Sharing Retirement Plan in excess of the amounts allowed by the Internal Revenue Service.

The Company had a separate plan available for its independent agents and agencies. The plan was 100% funded by the agents and agencies and included Group Life, Accidental Death and Dismemberment and Long-Term Disability.

## **TERRITORY AND PLAN OF OPERATION**

As of December 31, 2000, the Company was authorized to transact business in all states except New York and was authorized to transact business in the District of Columbia.

During the examination period, the Company adopted the strategy of moving from a product line orientation to distribution channels in which a single-entry-point system was used to deliver a complete franchise of life and investment products through multiple distribution points. The distribution points included banks, brokerage general agencies, broker dealers, registered investment advisors, investment consultants, retirement alliance partners, financial planners, third party administrators, and multi-line property and casualty agents. This system strategy incorporates the vision of one company. The purpose was to sell the entire SAFECO franchise and involved coordinating efforts with the other enterprises and SAFECO companies to work together as one company, one brand.

The Company used the following distribution Channels:

Multi-Line Channel: Life and investment products through existing property and casualty agents and former American States agents.

Investment Channel: Investment and asset management products through the Talbot Agency, Inc., SAFECO Select Insurance Services, Inc., and the bank platforms.

Group Third Party Administrators Channel: Life and investment products through broker dealers, third party administrators, consultant agents, and property and casualty agents.

Special Market Channel: For products that did not lend themselves to other channels because of market need or technical expertise required in selling the product. These products included structured settlements, BOLI (Banker's Only Life Insurance) and guaranteed investment contracts.

## **Products**

The Company offered services and products to meet a broad range of financial objectives. Life insurance, annuities and mutual funds can be used together or separately for a variety of financial solutions.

SAFECO Life offered the following products and services:

Retirement annuities, SEPs, SIMPLEs, tax sheltered annuities, 457 deferred compensation plans and qualified retirement plans

Qualified and non-qualified variable and fixed annuities

Group life and disability income insurance

Excess loss insurance for self-funded plans

Universal life, variable universal life and traditional term life insurance

Structured settlement annuities

BOLI (Banker's Only Life Insurance)

The Company sold the following life insurance and annuity products at December 31, 2000:

Life products included annual renewable term, level term, variable universal life, and universal life.

Annuity products included fixed and variable annuities.

The Company also sold structured settlements, retirement plans and group insurance.

As of December 31, 2000, the Company had one managing general agent or third party administrator. R. E. Moulton, Jr., of R. E. Moulton Insurance Agency, Marblehead, Massachusetts, was authorized to underwrite and pay claims on group life, accidental death and dismemberment, medical stop loss and disability income business it wrote. The premium written during 2000 totaled \$51,299,488.

## **GROWTH OF COMPANY**

The growth of the Company for the past five years is reflected in the following exhibit (000's omitted) prepared from copies of filed Annual Statements:

<u>Year</u>	<u>Assets</u>	<u>Liabilities</u>	<u>Capital</u>	<u>Surplus</u>	Premiums and Annuity <u>Considerations</u>
2000	\$16,527,667	\$15,821,710	\$5,000	\$700,957	\$1,795,027
1999	16,358,256	15,720,734	5,000	632,522	1,606,899
1998	14,791,114	14,214,323	5,000	571,791	1,537,700
1997	12,962,227	12,289,997	5,000	667,230	1,432,490
1996	11,526,325	10,938,667	5,000	582,658	1,393,816

## REINSURANCE

### Assumed

The Company assumed business from six nonaffiliated companies. As of December 31, 2000, the Company reported the following for reinsurance assumed:

<u>Description</u>	<u>Life</u>	<u>Accident and Health</u>
Premiums assumed	\$ 18,320,636	\$19,212,189
Reserve	21,119,114	5,831,046
Amount in force at end of year	184,159,696	-0-

### Ceded

The Company had nineteen active ceded reinsurance treaties in effect with thirteen nonaffiliated reinsurers. The active blocks of ceded individual life business encompassed six automatic treaties and one facultative treaty. The treaties provided coverage on individual lives in excess of the Company's retention of \$500,000. As of December 31, 2000, the Company reported the following for Life Insurance, Annuities, Deposit Funds and Other Liabilities without Life or Disability Contingencies, and Related Benefits and for Accident and Health business ceded:

<u>Description</u>	<u>Life</u>	<u>Accident and Health</u>
Premiums ceded	\$ 14,158,789	\$ 15,036,557
Reserve credit taken	15,032,246	62,065,083
Amount in force at end of year	6,888,255,191	-0-

Reinsurance agreements were reviewed for compliance with Washington reinsurance statutes. The reinsurers were verified as being authorized to do business in Washington and were properly classified in Schedule S of the Company's 2000 Annual Statement. Reserve credits were reviewed and verified during the actuarial phase of the examination. The Company appeared to be adequately monitoring its reinsurance program including the financial condition of the reinsurers. The overall reinsurance program appeared to be adequate for the Company's exposure and ability to assume risk.

## ACCOUNTS AND RECORDS

The external audit firm of Ernst and Young LLP was retained by the Company to audit the Company's statutory financial statements for the years under examination. Reports for 1999 and 2000 were provided as well as the work papers for 2000. As part of the audit work papers, the internal control structure noted deficiencies in the timely preparation of bank reconciliations and the clearance of items listed on the reconciliations.



The Internal Audit Department of the parent company, SAFECO Corporation, performed audits of the Company and provided recommendations to management on internal controls and operational procedures.

The Examiners independently tested internal controls and the following significant weaknesses were found:

- a) Bonds and Stocks – As demonstrated by the volume of monetary adjustments proposed for these invested assets, the Company was not in full compliance with RCW 48.05.280, which required maintenance of “full and adequate accounts and records of its assets, obligations, transactions and affairs.” It was recognized that some problems were due to the inadequacy of a software “crosscheck” package. However, such packages did not relieve the Company of its obligation to perform human oversight reviews of its financial statements before filing them.
- b) General Ledger Control (GLC) Accounts – Reconciliations between the general ledger and subsidiary records for a number of accounts, including cash, were centrally maintained for most SAFECO companies by one department, GLC. GLC identified differences between the general and subsidiary accounts and referred the specific items (variances) to the originating SAFECO department for investigation and potential correction. During the five-year period under examination, there were numerous variances that were not cleared but were continuously outstanding. This resulted from a lack of consistent accounting discipline and control and appropriate management guidance to clear variances on a timely basis. In mid-2002, the SAFECO Group of companies began the implementation of a new, stronger control process to ensure account accuracy and to control timely reconciliation of accounts.
- c) Cash – A number of instances were noted in which the cash administrative data base contained erroneous or incomplete information, including Company bank accounts which did not appear on the general ledger or in the data base. This condition resulted from the opening or amendment of bank accounts by parties other than those in the central bank administration department. Company employees must be made aware that only the bank administration department can open or change bank accounts.
- d) Cash Collections – “Deferred and Uncollected” premiums (D&U) received late in a month were recorded as a cash increase and included in a suspense (liability) account. This duplicated the receivable already included in the D&U asset balance. There was no surplus effect as the result of this discrepancy, but the total admitted assets and liabilities were overstated by a like amount. This was not in compliance with RCW 45.05.280.
- e) Short-Term Investments – Included in this asset were intercompany loans. These loans were made under a written agreement and were termed “Notes Receivable” in the Annual Statements. The loans were not supported by individual notes. The terminology should be changed to accurately describe the respective loans and notes should be executed for each loan. During the examination, there was extensive intercompany lending to an affiliate, SAFECO Credit Company. These loans were formalized by written notes, but the notes were often repaid long after their due dates. This recurring breach of terms was contrary to both normal business practices between borrowers and the Washington Insurer Holding Company Act.

The volume of intercompany borrowing and external short-term investing was extensive for the many related SAFECO companies, and it was handled by a small cash administration staff, without consistent external review. The situation was undesirable from the viewpoint of OIC examiners and the Company, since errors, oversights and omissions go undetected for long periods.

- f) Federal and State Withheld Taxes – Payments were combined into a new set of subsidiary accounts in 1999. New transactions were routed through the new accounts, but many of the old accounts were not reconciled and appropriately combined with the new accounts. As of mid-2002, many old account balances still persisted, making the new account balances wrong. The old accounts should be reconciled and appropriately cleared or combined into the new accounts.
- g) Intercompany Tax Settlements – Tax Settlements were not always concluded on a timely basis. This was in contravention of sound commercial practices and of the “third party” relationships implicitly required by the Washington Insurer Holding Company Act.
- h) Reinsurance Treaties – The treaties were not pre-assessed for potential economic results according to the Company’s answers to the Examination Questionnaire. Lacking such projections, it was not possible to completely and accurately evaluate the performance of reinsurance activities. The Company must utilize a structured pre-signing evaluation format.

During the examination, the Company engaged an external firm to guide and oversee the resolution of the many cash and other account reconciliations that had been in process for years and to put in place new procedures and controls.

### **OIC Actuarial Review**

The life actuary from the OIC reviewed the Company reserves as of December 31, 2000. The following concerns were noted:

Incurred but not reported (IBNR) reserves were calculated using factors of unknown origin. The IBNR reserves were determined to be inadequate by approximately \$487,000. No adjustments were made as the inadequacy was more than offset by the sufficiency of other reserves.

An incorrect factor was being used by the Company in the calculation of its traditional life business. The factor implicitly assumed that the average issue date within a month was at month-end, instead of appropriately assuming that the average date issued within a month was the middle of the month. No adjustments were necessary as the incorrect factor resulted in a more conservative reserve. The cost savings in 2000 was approximately \$1,300,000.

### **Electronic Data Processing System**

The management of the Company had sufficient knowledge of electronic data processing issues and provided direction and oversight through its Business Application Groups. Systems development, acquisition and maintenance controls were evaluated to gain assurance that programs and systems were

designed, tested, approved and implemented using appropriate controls. The internal controls in place provided for the proper separation of duties.

Operations and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed and the controls exercised to maintain data security. Adequate procedures and controls were in place for mainframe and network operations.

## **CONTINGENT LIABILITIES AND LEASES**

1. The Company had \$20,835,000 in unfunded mortgage loan commitments as of December 31, 2000.
2. The Company was obligated under a real estate lease with General America Corporation, an affiliate, which expires in 2010. The lease provided for minimum annual rental commitments of \$2,516,200 and for annual escalations limited to 5% per year, based upon the consumer price index. As of December 31, 2000, the total minimum obligation for the remaining life of the lease was \$24,529,500.

## **SUBSEQUENT EVENTS**

1. On December 20, 2002, the OIC issued Order No. 95 granting approval of a special consent investment. The Order, effective December 31, 2000, gave the Company special consent to acquire and hold the \$200,000,000 in Barrier Ridge LLC promissory notes in excess of the limitations contained in RCW 48.13.030 and RCW 48.13.240. The Order provided that the investments authorized by the Order may be credited to the Company's minimum capital or surplus or required reserves pursuant to RCW 48.13.250. The investments authorized by the Order shall be eligible for classification as admitted assets of the Company. The Order indicated that the Company desired to be in compliance with the OIC's interpretation of the Code, and so intends to divest itself of the Barrier Ridge LLC promissory notes no later than the end of the first quarter of 2003.

Schedule D, Part 4 of the Company's 2002 Annual Statement reported the disposal of the \$200,000,000 in Barrier Ridge LLC promissory notes on December 19, 2002. Schedule D, Part 4 indicated that the promissory notes had an adjusted carrying value of \$199,997,985 as of the disposal date, that the promissory notes had been decreased \$181,129 during 2002, that the name of the purchaser was "BARRIER RIDGE BOND" (should have been Barrier Ridge LLC), that the Company received a consideration of \$190,575,000, and that the Company had a realized loss of \$9,241,856. Note No. 10 to the financial statements contained in the Company's 2002 Annual Statement indicated that the Company received the consideration in cash.

2. On December 20, 2002, the OIC issued Order No. 94 granting approval of a special consent investment. The Order, effective December 31, 2000, gave the Company special consent to acquire and hold foreign securities in excess of the limitations contained in RCW 48.13.030 and

RCW 48.13.180. The Order provided that the investments authorized by this Order may be credited to the Company's minimum capital or surplus or required reserves pursuant to RCW 48.13.250. The investments authorized by the Order shall be eligible for classification as admitted assets of the Company. The Order indicated that the Company desired to be in compliance with the OIC's interpretation of the Code, and so intends to divest itself of these foreign securities no later than November 15, 2004, unless before that time the investments attain the standard of eligibility.

3. The NAIC adopted Statements of Statutory Accounting Principles (Codification) effective January 1, 2001. The effect of Codification resulted in a \$45,355,739 increase in the Company's 2001 statutory surplus.
4. Schedule D, Part 4 of the 2001 Separate Accounts Statement reported the transfer of two issues of Crown Cork & Seal bonds from Separate Accounts to SAFECO Life's Regular Accounts (Blue Annual Statement) on December 21, 2001. Schedule D, Part 5 of SAFECO Life's Regular Accounts reported a combined realized loss of \$8,991,630 as a "Basis Adjustment" made December 27, 2001 (six days after the transfer).

During the second quarter of 2002, the Regular Accounts acquired Xerox bonds having a par value of \$3,500,000 at a cost of \$1,662,500 from the Separate Accounts Statement. On June 19, 2002, the Company wrote down the Xerox bonds "Basis Adjustment" in Schedule D, Part 4 of its June 30, 2002 quarterly statement for the Regular Accounts.

5. On August 24, 2001, the Company amended its May 3, 1999 custodial agreement with The Bank of New York to conform to the NAIC Guidelines for custodial agreements.
6. On November 8, 2001, the Company's Bylaws were amended to revise the regular meeting verbiage. The reference to a specific meeting date each quarter was removed and replaced with wording that requires a quarterly meeting on a date and place to be specified. This amendment was made to allow the Board of Directors more flexibility and places the Company's bylaws in compliance with the other insurance companies within the SAFECO Group.
7. Schedule D, Part 4 of the Company's 2001 Annual Statement reported approximately \$49,000,000 in write downs for bonds issued by Comdisco, Crown Cork and Seal, Finova, Frontier Corporation, Greyhound, Heilig-Meyers, McSaver Financial, Shopko Stores, Unova, WestPoint Stevens, and Williams Communications and for preferred stock issued by Southern California Edison.

Schedule D of the quarterly reports covering the first 9 months of 2002 contained approximately \$109,000,000 in write downs for bonds issued by Adelphia Communications, Advanced Lighting, Bordens, Century Communications, Finova, Frontier Corporation, Heilig-Meyers, Intermedia Communications, Jet Equipment, K-Mart, MCI Communications, McLeod, NRG Energy, United Airlines, WorldCom and Xerox.

8. The Company paid its shareholder, SAFECO Corporation, \$112,000,000 in dividends in 2001 and \$50,000,000 in 2002.

9. Effective July 31, 2002, the Company acquired medical excess loss and group life business of Swiss Re Life & Health American Holding Company. The business acquired represented approximately \$240,000,000 in excess medical loss insurance premium and \$10,000,000 in annual group-life premium.
10. On December 20, 2002, the Company's parent, SAFECO Corporation, contributed \$100,000,000 in cash to the Company. The Summary of Operations in the Company's 2002 Annual Statement incorrectly reported the \$100,000,000 contribution as paid in capital rather than surplus paid in.

## **FINANCIAL STATEMENTS**

The following statements, with the exception of the Five Year Reconciliation of Capital and Surplus as stated by the Company, reflect the financial condition of the Company as of December 31, 2000, as determined by this examination:

Balance Sheet

As of December 31, 2000

Summary of Operations

For the Year Ended December 31, 2000

Capital and Surplus Account

For the Year Ended December 31, 2000

Reconciliation of Capital and Surplus

For the Five Year Examination Period (Per Company)

Comparative Analysis of Changes in Surplus

As of December 31, 2000

# SAFECO LIFE INSURANCE COMPANY

## Balance Sheet As of December 31, 2000

	<u>BALANCE PER COMPANY</u>	<u>NOTES</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>
<b><u>ASSETS</u></b>				
Bonds	\$ 11,710,329,213	1 to 3	\$ (10,198,485)	\$ 11,700,130,728
Stocks:				
Preferred stocks	238,897,394			238,897,394
Common stocks	107,918,909	4	(869,878)	107,049,031
Mortgage loans on real estate:				
First Lien	845,790,787			845,790,787
Real estate:				
Properties acquired in satisfaction of debt	2,971,313			2,971,313
Investment real estate	137,000			137,000
Policy loans	63,316,470			63,316,470
Cash and short-term investments	101,144,426	5	(1,956,369)	99,188,057
Other invested assets	126,959,324			126,959,324
Receivable for securities	17,970,410			17,970,410
Aggregate write-ins for invested assets	13,989,188			13,989,188
Reinsurance ceded:				
Amounts recoverable from reinsurers	2,184,780			2,184,780
Commissions and expense allowances due	(1,530,922)			(1,530,922)
Experience rating and other refunds due	289,892			289,892
Guaranty funds receivable or on deposit	1,844,385	6	(266,439)	1,577,946
Life insurance premiums and annuity considerations				
deferred and uncollected on in force business	31,826,590			31,826,590
Accident and health premiums due and unpaid	41,356,898			41,356,898
Investment income due and accrued	187,749,396	7	(148,919)	187,600,477
Receivable from parent, subsidiaries and affiliates	15,299,856			15,299,856
Aggregate write-ins for other than invested assets	3,366,270		-	3,366,270
<b>Total Assets excluding</b>				
<b>Separate Accounts business</b>	<b>\$ 13,511,811,579</b>		<b>\$ (13,440,090)</b>	<b>\$ 13,498,371,489</b>
From Separate Accounts Statement	3,015,855,021	8	(31,106,280)	2,984,748,741
<b>Total Assets</b>	<b><u>\$ 16,527,666,600</u></b>		<b><u>\$ (44,546,370)</u></b>	<b><u>\$ 16,483,120,230</u></b>

**SAFECO LIFE INSURANCE COMPANY**  
**Balance Sheet**  
**For the Year Ended December 31, 2000**

	BALANCE PER COMPANY	NOTES	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION
<b><u>LIABILITIES</u></b>				
Aggregate reserve for life policies and contracts	\$ 11,596,432,137		\$ -	\$ 11,596,432,137
Aggregate reserve for accident and health policies	8,976,851			8,976,851
Supplementary contracts without life contingencies	1,618,532			1,618,532
Policy and contract claims:				
Life	21,053,867			21,053,867
Accident and health	45,182,270			45,182,270
Policyholders' dividends and coupon accumulations	225,542			225,542
Provision for policyholders' dividends payable in following year	8,874			8,874
Premiums and annuity considerations received in advance	689,206			689,206
Liability for premium and other deposit funds:				
Policyholder premiums	1,354			1,354
Guaranteed interest contracts	588,230,012			588,230,012
Other contract deposit funds	222,496,521			222,496,521
Policy and contract liabilities not included elsewhere:				-
Interest maintenance reserve	57,407,846			57,407,846
Commissions to agents due or accrued	5,591,820			5,591,820
Commissions and expense allowances on reinsurance assumed	6,458,000			6,458,000
Transfers to Separate Accounts	(27,820,199)			(27,820,199)
Taxes, licenses and fees due or accrued (excluding federal and foreign income taxes)	10,670,751			10,670,751
Federal income taxes due and accrued	26,004,926			26,004,926
Cost of collection	834,496			834,496
Unearned investment income	1,065,436			1,065,436
Amounts withheld or retained by company as agent or trustee	2,142,487			2,142,487
Amounts held for agents' account	51,228	9	250,000	301,228
Remittances and items not allocated	42,798,749			42,798,749
Net adjustment in assets and liabilities due to foreign exchange	123,000			123,000
Miscellaneous liabilities:				
Asset valuation reserve	119,048,225			119,048,225
Payable to parent subsidiary and affiliates	1,644,972			1,644,972
Payable for securities	20,560,385			20,560,385
Aggregate write-ins for liabilities	40,699,560	10	459,926	41,159,486
<b>Total Liabilities excluding Separate Accounts business</b>	<b>\$ 12,810,193,492</b>		<b>\$ 709,926</b>	<b>\$ 12,810,903,418</b>
From Separate Accounts Statement	3,011,516,010		-	3,011,516,010
<b>Total Liabilities</b>	<b>\$ 15,821,709,502</b>		<b>\$ 709,926</b>	<b>\$ 15,822,419,428</b>
<b><u>CAPITAL AND SURPLUS</u></b>				
Common capital stock	\$ 5,000,000		\$ -	\$ 5,000,000
Gross paid in and contributed surplus	161,758,622			161,758,622
Unassigned funds (surplus)	539,198,476		(45,256,296)	493,942,180
<b>Total Capital and Surplus</b>	<b>\$ 705,957,098</b>		<b>\$ (45,256,296)</b>	<b>\$ 660,700,802</b>
<b>Total Liabilities, Capital and Surplus</b>	<b>\$ 16,527,666,600</b>		<b>\$ (44,546,370)</b>	<b>\$ 16,483,120,230</b>

**SAFECO LIFE INSURANCE COMPANY**  
**Summary of Operations**  
**For the Year Ended December 31, 2000**

	BALANCE PER COMPANY	ADJUSTMENTS	BALANCE PER EXAMINATION
Premiums and annuity considerations	\$ 1,795,026,599	\$ -	\$ 1,795,026,599
Deposit-type funds	133,753,670		133,753,670
Consideration for supplementary contracts without life contingencies and dividend accumulations	352,102		352,102
Net investment Income	1,043,950,885		1,043,950,885
Amortization of interest maintenance reserve	4,911,607		4,911,607
Separate Accounts net gain from operations excluding unrealized gains or losses	933,013		933,013
Commissions and expense allowances on reinsurance ceded	4,300,639		4,300,639
Reserve adjustments on reinsurance ceded	502,929		502,929
Income from fees associated with investment management, administration and contract guarantees from Separate Accounts	26,367,754		26,367,754
Aggregate write-ins for miscellaneous income	16,598,395	-	16,598,395
<b>Total Income</b>	<b>\$ 3,026,697,593</b>	<b>\$ -</b>	<b>\$ 3,026,697,593</b>
Death benefits	\$ 56,975,593	\$ -	\$ 56,975,593
Matured endowments	17,723		17,723
Annuity benefits	560,574,241		560,574,241
Disability benefits and benefits under accident and health policies	195,298,160		195,298,160
Surrender benefits and other fund withdrawals	1,507,383,783		1,507,383,783
Interest on policy or contract funds	56,319,968		56,319,968
Payments on supplementary contracts without life contingencies and of dividend accumulations	597,542		597,542
Increase in aggregate reserves for life and accident and health policies and contracts	(290,951,082)		(290,951,082)
Increase in liability for premium and other deposit funds	(195,471,304)		(195,471,304)
Increase in reserve for supplementary contracts without life contingencies and for dividend and coupon accumulations	(186,997)		(186,997)
Commissions on premiums, annuity considerations and deposit-type funds	93,813,276		93,813,276
Commissions and expense allowances on reinsurance assumed	5,178,813		5,178,813
General insurance expenses	149,247,152		149,247,152
Insurance taxes, licenses and fees, excluding federal income taxes	26,761,252		26,761,252
Increase in loading on and cost of collection	(38,104)		(38,104)
Net transfers to or (from) Separate Accounts	724,168,918		724,168,918
Aggregate write-ins for deductions	(29,846,000)	-	(29,846,000)
<b>Totals</b>	<b>\$ 2,859,842,934</b>	<b>\$ -</b>	<b>\$ 2,859,842,934</b>
<b>Net gain from operations before dividends to policyholders</b>	<b>\$ 166,854,659</b>	<b>\$ -</b>	<b>\$ 166,854,659</b>
Dividends to policyholders	5,692	-	5,692
<b>Net gain from operations before federal income taxes</b>	<b>\$ 166,848,967</b>	<b>\$ -</b>	<b>\$ 166,848,967</b>
Federal income taxes incurred	54,476,713	-	54,476,713
<b>Net gain from operations before realized capital gains</b>	<b>\$ 112,372,254</b>	<b>\$ -</b>	<b>\$ 112,372,254</b>
Net realized capital gains or (loses) less capital gains tax	(49,008,004)	-	(49,008,004)
<b>Net Income</b>	<b>\$ 63,364,250</b>		<b>\$ 63,364,250</b>



**SAFECO LIFE INSURANCE COMPANY**  
**Capital and Surplus Account**  
**For the Year Ended December 31, 2000**

	<u>BALANCE</u> <u>PER COMPANY</u>	<u>NOTES</u>	<u>EXAMINATION</u> <u>ADJUSTMENTS</u>	<u>BALANCE PER</u> <u>EXAMINATION</u>
<b><u>CAPITAL AND SURPLUS ACCOUNT</u></b>				
Capital and Surplus, December 31 Previous Year	\$ 637,522,456		\$ -	\$ 637,522,456
Net income	\$ 63,364,250			\$ 63,364,250
Change in unrealized capital gains or (losses)	5,259,652	1 to 5	(13,024,732)	(7,765,080)
Change in non-admitted assets and related items	(43,355,442)	6, 7	(415,358)	(43,770,800)
Change in asset valuation reserve	15,532,879			15,532,879
Change in liability for amounts held for agents account		9	(250,000)	(250,000)
Change in liability for aggregate write-ins for liabilities		10	(459,926)	(459,926)
Surplus (contributed to) withdrawn from Separate Accounts during period	2,380,787			2,380,787
Other changes in surplus in Separate Accounts Statement	(2,556,110)	8	(31,106,280)	(33,662,390)
Surplus adjustment:				
Paid in	76,758,626			76,758,626
Dividends to stockholders	(48,950,000)		-	(48,950,000)
 Net change in capital and surplus for the year	 \$ 68,434,642		 \$ (45,256,296)	 \$ 23,178,346
 Capital and Surplus, December 31 Current Year	 \$ 705,957,098		 \$ (45,256,296)	 \$ 660,700,802

**SAFECO LIFE INSURANCE COMPANY**  
**Reconciliation of Capital and Surplus**  
**For the Five Year Examination Period**  
**(Per Company)**

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
<b>Capital and Surplus, December 31</b>					
<b>Previous Year</b>	<u>\$ 637,522,456</u>	<u>\$ 576,791,355</u>	<u>\$ 672,229,778</u>	<u>\$ 587,657,972</u>	<u>\$ 504,682,909</u>
Net income	\$ 63,364,250	\$ 91,666,158	\$ 64,599,100	\$ 95,012,413	\$ 95,676,197
Change in net unrealized gains or (losses)	5,259,652	(232,713)	(182,103)	682,622	(2,991,625)
Change in non-admitted assets and related items	(43,355,442)	1,276,205	644,000	(474,759)	262,592
Change in reserve on account of change in valuation basis			(53,019,202)		
Change in asset valuation reserve	15,532,879	(32,083,847)	(8,670,686)	5,351,530	(5,972,101)
Surplus (contributed to) withdrawn from Separate Accounts during period	2,380,787	(100,445)	52,756		
Other changes in surplus in Separate Accounts Statement	(2,556,110)	205,743	(150,894)	(11,482,334)	
Surplus adjustment:					
Paid in	76,758,626				
Dividends to stockholders	(48,950,000)		(90,000,000)	(16,000,000)	(4,000,000)
Aggregate write-ins for gains and losses in surplus	<u>                    </u>	<u>                    </u>	<u>(8,711,394)</u>	<u>11,482,334</u>	<u>                    </u>
<b>Net change in capital and surplus for the year</b>	<u>\$ 68,434,642</u>	<u>\$ 60,731,101</u>	<u>\$ (95,438,423)</u>	<u>\$ 84,571,806</u>	<u>\$ 82,975,063</u>
<b>Capital and Surplus, December 31 Current Year</b>	<u><b>\$ 705,957,098</b></u>	<u><b>\$ 637,522,456</b></u>	<u><b>\$ 576,791,355</b></u>	<u><b>\$ 672,229,778</b></u>	<u><b>\$ 587,657,972</b></u>

**SAFECO LIFE INSURANCE COMPANY**  
**Comparative Analysis of Changes in Surplus**  
**As of December 31, 2000**

The following is a reconciliation of surplus as regards policyholders between that reported by the Company and as determined by the examination:

	<u>PER</u> <u>COMPANY</u>	<u>PER</u> <u>EXAMINATION</u>	<u>NOTES</u>	<u>INCREASE</u> <u>(DECREASE)</u> <u>IN SURPLUS</u>	<u>TOTALS</u>
<b>Capital and Surplus, December 31,</b> <b>2000 - Per Annual Statement</b>					<b>\$ 705,957,098</b>
<b><u>ASSETS</u></b>					
Bonds	\$ 11,710,329,213	\$ 11,700,130,728	1 to 3	\$ (10,198,485)	
Stocks:					
Common stocks	107,918,909	107,049,031	4	(869,878)	
Cash and short-term investments	101,144,426	99,188,057	5	(1,956,369)	
Guaranty funds receivable or on deposit	1,844,385	1,577,946	6	(266,439)	
Investment income due and accrued	187,749,396	187,600,477	7	(148,919)	
From Separate Accounts Statement	3,015,855,021	2,984,748,741	8	(31,106,280)	
<b><u>LIABILITIES</u></b>					
Accounts held for agents' account	51,228	301,228	9	(250,000)	
Aggregate write-ins for liabilities	40,699,560	41,159,486	10	<u>(459,926)</u>	
Change in surplus					<u>\$ (45,256,296)</u>
<b>Capital and Surplus, December 31,</b> <b>2000 - Per Examination</b>					<b><u>\$ 660,700,802</u></b>

## **NOTES TO FINANCIAL STATEMENTS**

1. Bonds - The Company had an investment in the promissory notes of Barrier Ridge LLC, an affiliate. As of December 31, 2000, the promissory notes had an admitted value of \$200,000,000 and \$417,850 in accrued interest. It was determined that the investment in Barrier Ridge LLC was in violation of a number of statutes and the Company was instructed to comply with the remedies contained in RCW 48.31B.050(3). The remedies and penalties under the code do not provide for the nonadmission of the asset, only cease and desist, avoidance of the transactions and possible monetary penalties. See "INSTRUCTIONS" No. 3, Bonds – Investment in Barrier Ridge LLC.
2. Bonds - As of December 31, 2000, the Company had invested in foreign bonds having an admitted value of \$159,931,609 and \$2,230,952 in accrued interest. RCW 48.13.180 prohibited the Company's investment in foreign securities. The remedies under the code did not provide for the nonadmission of the foreign securities. See "INSTRUCTIONS" No. 4, Prohibited Investments in Foreign Securities.
3. Bonds - As of December 31, 2000, the Company had an investment in Principal Protected Equity Linked Trust having an admitted value of \$10,198,485 and no accrued interest. The security was acquired from Morgan Stanley & Company as Book Entry Agent and the confirmation at the time of acquisition indicated that SAFECO Asset Management Company, an affiliate, was the beneficial owner. The security has been reported as a nonadmitted asset on the financial statements of this report as it was in violation of RCW 48.12.010 which required that the security be registered, recorded or held under the insurer's name and was a violation of RCW 48.13.450 which prohibits a broker from holding securities for an insurer. See "INSTRUCTIONS" No. 5, Bonds – Investment in Principal Protected Equity Linked Trust.
4. Stocks: Common Stocks - Based on filings made by the Company with the Securities Valuation Office of the NAIC, the December 31, 2000 assigned values for subsidiaries, D. W. Van Dyke & Co., Inc., and Medical Risk Managers, Inc., were \$869,878 less than the Company's admitted value. The \$869,878 in adjustments has been reported as a nonadmitted asset on the financial statements of this report. See "INSTRUCTIONS" No. 6, Common Stock – Investment in Affiliates Improperly Valued.
5. Cash and Short-Term Investments - The AIP Commercial Paper having a \$1,956,369 admitted value as of December 31, 2000 could not be confirmed during the examination. The admitted value of this short-term investment has been reported as a nonadmitted asset on the financial statements of this report. See "INSTRUCTIONS" No. 7, Short-Term Investment Not Confirmed.
6. Guaranty Funds Receivable or on Deposit - Guaranty funds having a December 31, 2000 admitted value of \$266,439 were not available for future offsets to taxes. The \$266,439 in guaranty funds has been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 8, Guaranty Funds on Deposit Not Allowed as Future Offset to Taxes.
7. Investment Income Due and Accrued - The Company was unable to support \$148,919 of the accrued interest on derivative instruments. The \$148,919 in accrued interest has been

nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 9, Accrued Interest on Derivative Instruments Not Supported by Company.

8. From Separate Accounts Statement - Four mutual funds having a December 31, 2000 admitted value of \$31,106,280 were held and recorded in the name of SAFECO Mutual Funds rather than SAFECO Life Insurance Company. RCW 48.12.10 required that only those assets that belong wholly and exclusively to the insurer that are registered, recorded or held under the insurer's name shall be allowed as an asset. The \$31,106,280 in investments has been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 10, Separate Accounts Statement – Mutual Fund Accounts Not in Company's Name.
9. Amounts Held for Agents' Account - The December 31, 2000 liability reported by the Company included a \$250,000 debit error made by the Company in its attempt to reverse a previous entry. The liability has been credited \$250,000 on the financial statements of this report. See "INSTRUCTIONS" No. 11, Error in Liability for Amounts Held for Agents' Account.
10. Aggregate Write-Ins for Liabilities - The December 31, 2000 liability reported by the Company contained a \$459,926 unreconciled variance. The liability has been increased \$459,926 on the financial statements of this report. See "INSTRUCTIONS" No. 12, Unreconciled Balance in Account Included in Aggregate Write-Ins for Liabilities.

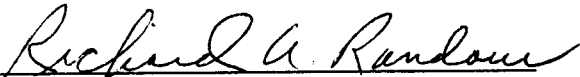
## **ACKNOWLEDGMENT**

Examiners John J. Gaynard, CPA, CPCU, AFE; Peter M. Mendoza, CFE, CIE; Orlando R. Gabriel, Kehinde Ovbiebo, Constantine Arustamian, CPA; Mike Bosley, CPA; Charles J. Mitchell, CPA; Mitch Coe, CPA; Alexis S. Santos, FSA, MAAA, Associate Actuary, and Michael V. Jordan, CPA, CFE, MHP, Assistant Chief Examiner, from the Washington State Office of Insurance Commissioner, and Larry E. Cross, CFE, CIE, from the State of Delaware participated in the examination and preparation of this report.

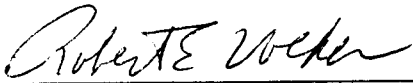
Respectfully submitted,



TIMOTEO L. NAVAJA, CFE, CIE  
Examiner-in-Charge  
Office of Insurance Commissioner  
State of Washington



RICHARD A. RANDOUR, CFE, CPA  
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NAIC Northeastern Zone




ROBERT E. VOLKER, CFE, CIE  
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NAIC Western Zone

# AFFIDAVIT

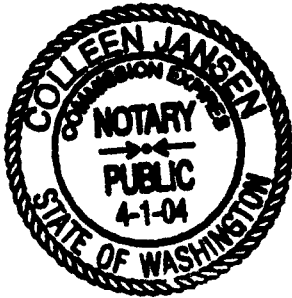
STATE OF WASHINGTON )  
 ) SS  
COUNTY OF KING )

Timoteo L. Navaja, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

He attests that the examination of SAFECO Life Insurance Company was performed in a manner consistent with the standards and procedures required or prescribed by the Washington State Office of Insurance Commissioner and the National Association of insurance Commissioners (NAIC).

  
TIMOTEO L. NAVAJA, CFE, CIE  
Examiner-in-Charge

Subscribed and sworn to before me on this 11<sup>th</sup> day of September, 2003.



Colleen Jensen  
Notary Public in and for the  
State of Washington,  
residing at Seattle.  
My commission expires 4/1/04.